

**UNITED STATES OF AMERICA**  
**Before The**  
**FEDERAL ENERGY REGULATORY COMMISSION**

San Diego Gas & Electric Company  
Complainant,

v.

Docket No. EL00-95-012

Sellers of Energy and Ancillary Services  
Into Markets Operated by the California  
Independent System Operator and the  
California Power Exchange,  
Respondents.

**COMMENTS OF THE**  
**CALIFORNIA DEPARTMENT OF WATER RESOURCES**

The California Department of Water Resources ("DWR") respectfully provides the following comments on Prospective Market Monitoring And Mitigation For The California Wholesale Electric Power Market in the above-captioned docket. These comments, which are based on DWR's recent purchasing experience in California markets, build upon the positions set forth in DWR's March 23, 2001 comments in this docket.

As described in greater detail in the attached affidavit of Deputy Director Raymond D. Hart, California energy markets are not reasonably competitive. Unlike in competitive markets, sellers know that in most cases all bids will be accepted because there is no surplus of suppliers to meet demand. **Thus economic theory holding that bidders might be constrained to bid their marginal price of energy production has nothing to do with reality. *Nothing* constrains supply bidding in today's market.**

In these market conditions, suppliers naturally position themselves to make the most of any opportunities presented. They have, through their experience in demand and supply patterns in California as played out over the past years' auction markets, become highly sophisticated and intelligent in their use of strategies to maximize profits. Thus greater opportunities to maximize profits in a "must take" real time or hourly market with a single market clearing price auction draws supply to those markets—defeating objectives to move greater volumes into day ahead or longer forward markets.

Already, higher retail prices and calls for conservation are producing reductions in California's demand. Further price increases or involuntary, uneconomic reductions in power usage in the near term portend enormous damage to the economies of California, the nation, and possibly the world. Thus the critical time is *now*.

Briefly, the Commission should:

- 1) Abandon the single market clearing price auction until such time as the supply/demand imbalance is no longer such that all supply bids are guaranteed to be accepted, and instead employ an "as bid" pricing mechanism.
- 2) Apply a unit-specific cost-basis to all timeframes—not merely to Stage 3 emergencies.
- 3) Ensure that destabilizing spot markets are not more attractive to sellers than the forward markets the Commission seeks to promote.

**1) Because a single market-clearing price auction only promotes excessive pricing in markets where supply bidders know virtually all bids will be taken, real time markets should be priced “as bid.”**

Suppliers bidding into current single price market clearing auctions in California know that almost all bids will be accepted. Thus they know they face virtually no risk of rejection if they bid unrealistically high prices. Their prices need not—and as FERC has held in recent orders requiring refunds, do not—bear any relationship to the marginal cost of energy production. In such circumstances, the most exorbitant bid always prevails.

Bidders who do confine themselves to pricing based on energy production costs, bidders whose inherently low costs are reflected in their bids, or others who seek only reasonable margins receive only the highest price. Indeed, DWR’s State Water Project has *complained* that this single price scheme can be highly inappropriate as applied to load or dedicated purpose generation, such as hydro used for water deliveries, and has sought a LAST RESORT flag and “as bid” payment in lieu of a single market clearing price. By giving all bidders the highest clearing price, the single price auction robs responsible bidders of any opportunity to obtain only reasonable prices. It also denies buyers any opportunity to select only reasonably priced bids.

Based on recent experience, DWR strongly recommends that in the near term, until supply and demand comes into better balance, real time markets be paid on an “as bid” basis. Such an approach will empower buyers to select only reasonably priced products, and it will enable those sellers who seek to act responsibly to do so. Moreover, this approach would enable buyers and sellers to reach appropriate prices based on

conditions not recognized in the grid-wide auction. For instance, power may have legitimately different values at different points on the grid, yet high prices in one specific location may cause prices to become artificially elevated throughout the system.

**2) Unit-specific, cost-based pricing should apply to real-time markets in all periods—not just Stage 3 emergencies.**

Under the Federal Power Act, the Federal Energy Regulatory Commission is required to regulate sellers and their sales to ensure just and reasonable pricing. Commission Staff found the \$150 break point in the December 15, 2000 order unsuccessful. To date, mitigation of market power has simply not occurred. Accordingly, unit-specific, cost-based pricing should be applied to spot or real-time markets in this period of unbridled generator market power.

At present, any Commission effort at price mitigation has been limited to Stage 3 alerts. As a result, from a purchasing perspective, Stage 3 emergencies hold the perversely attractive prospect of reducing costs. From the seller's perspective, pricing constraints have no meaning unless a Stage 3 alert is in progress. If anything goes until Stage 3 is in effect, further destabilization must be expected. DWR's experience indicates that application of an "as bid" pricing approach—which is currently used for certain out of market calls—with the application of unit-specific, cost-based pricing for spot markets, may encourage movement to day ahead markets.

**3) The reforms above should ensure that near- or real-time markets will not be more attractive to suppliers than forward markets, thus drawing supply away from forward contracting.**

As the Commission has recognized in urging movement toward greater forward contracting, excessive use of spot markets is highly destabilizing. As noted above, in this sellers' market, FERC-regulated generation is facing few if any constraints on pricing or choice of markets. In these circumstances, Commission policies should not promote further destabilization through policies that make the real-time market more attractive than forward contracting on negotiated terms and conditions.

DWR respectfully submits that the first two simple suggestions submitted above will encourage movement toward forward contracting, as discussed in the third recommendation. DWR's purchaser observations in this kind of sellers' market should carry great weight. Commission action resulting in greater complexities or greater burdens on purchasers in such a market must be expected to exacerbate the crisis.

WHEREFORE, the California Department of Water Resources respectfully requests that the Commission act upon Market Mitigation in a manner consistent with these comments.

Respectfully submitted this 23rd day of April, 2001.

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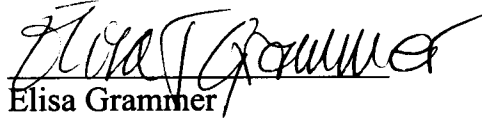
Attorneys for the

CALIFORNIA DEPARTMENT OF WATER RESOURCES

**CERTIFICATE OF SERVICE**

I hereby certify that I have served the foregoing document by first-class mail on each party identified on the service list in this proceeding.

Dated at Washington, DC this 23d day of April, 2001.

A handwritten signature in black ink, appearing to read "Elisa Grammer", written over a horizontal line.

Elisa Grammer

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## AFFIDAVIT OF RAYMOND D. HART

I, Raymond Hart, being first duly sworn, on oath depose and state as follows:

- 1) My name is Raymond Hart, and I am Deputy Director of the California Department of Water Resources. In this capacity I oversee purchases by the California Energy Resources Scheduler, which since January of this year has purchased power to meet the net short needs of California's major investor-owned utilities. In this position, I have observed the behavior of power markets in California.
- 2) At present, power sellers have significant incentives to withhold power from forward contracting in day ahead or longer markets. The single price market clearing auction available in the real-time or spot market presents an advantage of essentially unlimited prices without adverse consequences. Currently the supply/demand balance is such that all sellers know that in most cases, all bids will be accepted. Low bids receive the very highest price. In some cases, bidders with lower energy production costs may bid at prices reflective of their costs, but the highest price prevails. Similarly, purchasers in the single price auction have no ability to select lower cost power in the real time.
- 3) In contrast, out of market dispatches in the real time are priced as bid, and this model has been workable. In fact, DWR has asked that its loads and dedicated purpose hydro generation used for water deliveries be able to use a LAST RESORT designation that would be paid "as bid," so as to be *permitted* to participate responsibly in real time markets.
- 4) Significant increases in retail rates, plus conservation measures, are beginning to show results in lowering demand in California. We have seen reductions of some 9% in recent weeks. Further price increases—or further uneconomic reductions in electric usage—portend very serious adverse effects on California's economy. This in turn must be expected to have negative impacts on the national and global economies. Such

consequences must be balanced in determining how to ensure just and reasonable rates under the Federal Power Act.

5) In short, my observations have led to me to develop the conclusion in the past few weeks that measures must be taken to move FERC-regulated suppliers—not merely purchasers—into the forward markets. Suppliers, and not purchasers, hold the leverage in this sellers' market. Purchasers have little ability to move toward forward markets if spot markets are perceived as more lucrative or attractive to suppliers. Over the past years' experience in California auctions, suppliers have developed very sophisticated approaches to employing market strategies to maximize profit. Currently, *all* participants in spot markets may receive the highest price for the entire ISO grid, whereas suppliers in forward markets are subject to downward price pressures depending on buyer resistance, the location of power, negotiating strategies and other factors not permitted in the single price auction.

6) To encourage movement toward greater use of forward contracting, the spot market should be priced as bid, and it should be subject to unit-specific cost-based pricing at all times, not just in times of Stage 3 alerts. The current practice of restricting price review to Stage 3 periods has perverse effects. For the buyer, this makes Stage 3 more attractive from a pricing perspective, and we have in fact seen prices go down in Stage 3 periods. Restricting price scrutiny to Stage 3 episodes gives sellers the confidence that any exorbitant spot price is "just and reasonable" so long as it does not occur during a Stage 3 alert.

I, Raymond D. Hart, swear on this 23rd day of April, 2001 under penalty of perjury that the foregoing affidavit was prepared under my supervision and is accurate to the best of my knowledge and belief.



Raymond D. Hart

Deputy Director, California Department of Water Resources